1 November 2018
Equity Research
research@armsecurities.com.ng
+234 1 270 1652

Fidelity Bank Plc. (FIDELITY.NL)

Stock Report

Rating	**BUY**
Price	₦2.04
FVE	**₦2.92**
52-week range	₦1.51 – ₦4.33
Market Cap. (₦'mn)	59,109
1-month Avg. Vol	12,649,430
Curr. P/B	0.31x

FIDELITY:NL - Share Price Trend

Analyst(s)

Emmanuel Adeleke
emmanuel.adeleke@arm.com.ng

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Stock Report: Love at 'second' Sight

H1 2018 Initial View: Earnings Breaking Limits

Our preferred Tier 2 Bank

- Fidelity Bank posted its nine-month 2018 result which was impressive on the back of a 55% YoY decline in loan-loss provision which masked the weak non-interest revenue (NIR) and lower operating efficiency. The result came slightly above our expectation with 9M 18 EPS (₦0.62) printing at 81% of our FY 18E EPS of ₦0.82. Relative to our expectation, the variance stemmed from a slower growth in funding cost as well as lower than expected loan-loss provisioning.

- Following discussion with management via its conference call on Tuesday, we have updated our model on the bank and made specific revisions to our estimate. Specifically, we made a downward adjustment to NIR informed by our expectation of lower growth on net fee income and net gains from financial instruments. We have also revised our funding cost lower to 7.2% (previously 7.4%) which should drive a 40bps expansion in FY 18E NIMs to 6.2%. Elsewhere, we have reviewed our loan growth forecast higher to 10% (previously: +6% YoY) given current run rate of 8% YTD. Consequently, asset yield should print slightly higher at 14.3% (Previously 14.2%). On asset quality, we have revised our Cost of Risk forecast for 2018 lower to 0.6% (previously 1.0%) which now informs loan-loss provision of ₦5.1 billion (previously: ₦8.2 billion).

- On balance, we are now more optimistic over our expectation for earnings growth. Net impact of our adjustment translates to an EPS of ₦0.82 (previously ₦0.76) in FY 2018 (FY 19E: ₦1.09).

- Over FY 2018, we expect ROAE to expand 108bps YoY to 10.8% and average 12.3% over the next four years. Post adjustments, our FVE for Fidelity increases to **₦2.92 (vs. ₦2.82 previously).** We maintain our **BUY** recommendation on the stock. Fidelity trades at a FY 18E P/B of 0.36x, a premium to Diamond (0.14x) and FCMB (0.18x), which we think is justified based on its first-rate ROAE (10.8%) in FY 18E relative to Diamond (2.1%) and FCMB (6.0%). At current price, our expected dividend of ₦0.15 over FY 18E translates to a dividend yield of ~7%.

Lower NIR but earnings making wave

- Parsing through the breakdown, funding cost (-192bps YoY to 6.1%) came in significantly lower but was outweighed by a decline in asset yield[1] (-130bps YoY to 13.3%) resulting to a mild contraction in NIMs (-69 bps YoY to 6.4%). According to management, the lower funding cost over the period reflected improved deposit pricing as average cost of deposits dropped to 6.2% from 7.2% in 9M 17. To buttress, growth in CASA as a share of total deposit was relatively flat at 73.6% (9M 17: 73.5%). Consequently, expansion in interest expense (+9.8% YoY to ₦62.2 billion) was largely driven by growth in borrowing cost (+54% YoY to ₦16.8 billion) and to a less extent growth in interest expense on customer deposits (+1.0% YoY to ₦45.4 billion).

- ***Lower impairment charge buoys earnings.*** Surprisingly, the bank posted a faster than expected decline in loan-loss provisioning (-55% YoY to ₦3.3 billion) with Cost of Risk moderating to a record 9M low of 0.53% (-77 bps YoY). From our discussion with management, we believe the bank has made adequate provisioning following the implementation charge[2] on IFRS 9 in Q1 2018 which was charged to the bank's regulatory risk reserve[3]. Supporting the decline was also a write back of ₦3.3 billion on loans to the manufacturing sector which was booked in H1 18. Asset quality continued to fare better with NPL ratio declining 40bps YTD to 6.0%, almost below the bank's target for FY 18. Capital adequacy maintained its stance in Q3 18 at 17.0% and currently 100bps higher YTD.

- ***Lower FX gains drives NIR lower.*** Over 9M 18, NIR moderated 8.7% YoY to ₦15.7 billion. As mentioned earlier, the bank did a reclassification from its NIR to interest income. Specifically, gains amounting to ₦3.8 billion and ₦3.4 billion was reclassified from credit related fees and interest income on financial assets measured at FVTPL respectively to interest income. Irrespective, despite an increase in fee income (+12% YoY to ₦12.5 billion), the lower NIR reflected a sharp moderation in FX gains (-46% YoY to ₦2.6 billion). On other front, operating expenses surged

[1] This reflects lower asset yield on investment securities
[2] Amounting to N28 billion
[3] This account represents the difference between the allowance for impairment losses as required by GAAP and IFRS

6.5% YoY to ₦50.6 billion largely on account of higher AMCON charge (+29.8% YoY to ₦6.3 billion) with Cost to Income ratio climbing 160 bps YoY to 68.4%.

- ***Q3 Earnings.*** Pressure on asset yield was more telling on earnings in Q3 standalone with interest income declining 3.0% QoQ to ₦40.4 billion. Also, the bank faced pressure from lower NIR (-13.1% QoQ to ₦5.5 billion). On balance, despite a decline in loan-loss provision (-63.4% QoQ to ₦692 million) and lower funding cost (-1.2% QoQ to ₦20.2 billion), net impact of lower interest income and weak NIR drove PBT lower by 12.1% QoQ to ₦7.1 billion.

Summary of Results

₦'million	9M 2018	9M 2017	YoY (pps)	Q3 18	Q2 18	QoQ
Gross Earnings	139,001	130,086	6.85%	50,084	45,237	10.71%
Net Interest Income	58,168	53,805	8.11%	20,110	21,091	-4.65%
Non-Interest Revenue	15,736	17,242	-8.73%	5,532	6,368	-13.13%
Operating Expenses	(50,556)	(47,487)	6.46%	(17,897)	(17,540)	2.04%
Impairment	(3,285)	(7,323)	-55.14%	(692)	(1,891)	-63.41%
PBT	20,063	16,237	23.56%	7,053	8,028	-12.14%
PAT	17,856	14,451	23.56%	6,013	7,216	-16.67%
EPS	**0.62**	**0.50**	23.56%	**0.21**	**0.25**	-16.67%
₦'million	**Q3 2018**	**Q2 2018**	**QoQ**			
Loans	830,375	795,368	4.40%			
Total Assets	1,680,804	1,567,563	7.22%			
Deposits	986,830	927,933	6.35%			
Total Liabilities	1,488,417	1,383,397	7.59%			
Net Assets	192,387	184,166	4.46%			
BVPS	**6.64**	**6.36**	4.46%			
	9M 2018	**9M 2017**	**change (pps)**	**Q3 18**	**Q2 18**	**change (pps)**
Assets Yields	13.30%	14.59%	-1.30%	10.09%	11.21%	-1.12%
WACF	6.32%	8.14%	-1.82%	5.99%	6.43%	-0.44%
Net Interest Margin	6.42%	7.11%	-0.69%	5.94%	6.78%	-0.84%
Cost-Income Ratio	68.41%	66.84%	1.57%	69.80%	63.88%	5.92%
Cost of Risk	0.53%	1.30%	-0.77%	0.33%	0.95%	-0.62%
ROE	12.38%	9.61%	2.77%	12.77%	15.57%	-2.79%
CAR	17.00%	17.30%	-0.30%			

Key take-away from Conference Call

- **Loan Book Growth.** Management is comfortable with its loan book growth despite the loan book moderation by peers. Growth in loan book was driven by Oil & Gas (Services), Manufacturing, Transport and Government sectors. These four sectors accounted for 70% of the increase in loan book.

- **Reclassification of Income.** After close look by auditors, gains amounting to ₦7.2 billion from Non-interest revenue had to be reclassified to interest income after a review of the underlying transactional income. According to management, this reclassification involved gains which are tied to interest earnings but erroneously recorded as Non-interest revenue.

- **FX translation**. Following the convergence in the NIFEX and NAFEX rate, the bank expects to book revaluation gains and income accretion in Q4 on the back of its net long dollar position (~$200 million). FCY makes up 15% of the bank's NPL and expected provisioning on this front should not exceed ₦1.5 billion. On balance, management does not expect this translation to affect profitability.

- **9Moble Exposure:** Management highlighted that no provision was booked on its exposure to 9Mobile in Q3. The bank has made a total of 50% provisioning on this exposure and does not expect any additional provisioning.

Revision to forecast

- We have revised our Cost of Risk forecast for 2018 lower to 0.6% (previously 1.0%) on the back of adequate provisioning made so far and also an improving macro-economic landscape. We maintain our NPL ratio at 6.1% for FY 18 (FY 19: 5.3%). Despite our expectation for additional impairment in Q4 on the back of convergence in the NIFEX and NAFEX rate, we remain optimistic concerning lower impairment charge for FY 2018 (-55.3% YoY to ₦5.1 billion). To add, we expect to see additional write-backs in the coming periods.

- ***NIR to print lower YoY.*** Following the reclassification of Non-interest revenue, we see lower growth on net fee income and net gains from financial instruments. We now see fee income growing at 15.4% YoY (previously: 41% YoY) to ₦16.8 billion on the back of expansion in credit related fees. Despite gains on this front, lower FX gains (-50% YoY to ₦5.5 billion) over 2018 should leave NIR depressed. For context, the duo impact of high base from last year with current convergence between the NAFEX and NIFEX presenting a constraint to booking additional FX gain informs our expectation for lower FX gains. On balance, NIR should decline 12.5% YoY to ₦22.6 billion.

- ***Higher loan growth to drive net interest income.*** We had earlier expected higher growth in funding cost to put pressure on Net Interest Earnings. Now, we see support from interest income following the reclassification of NIR to interest income and also our higher loan book growth forecast. For emphasis, we expect interest income to grow by 8.4% YoY to ₦163.4 billion largely on the back of higher income from customer loans (+8.1% YoY to ₦118.1 billion). Elsewhere, interest income from investment securities should expand 9.9% YoY to ₦40.1 billion). On the other hand, we still expect interest expense (₦88.0 billion) to grow at a faster pace of 11% YoY largely on the back of higher borrowing cost (+33.5% YoY to ₦22.4 billion) and to an extent higher funding cost on term deposits (+4.9% YoY to ₦54.8 billion). On balance, we expect Net Interest Income to expand 5.9% YoY to ₦75.7 billion.

- Elsewhere, we maintain our forecast for operating expense (2.4% YoY to ₦67.3 billion) with Cost-to-Income (CIR) expected to print at 68.4% (FY 17: 67.5%). Net impact of our overall adjustment translates to PBT of ₦25.9 billion (Previously ₦24.1 billion) over FY 18E. Thus, we estimate EPS of ₦0.82 (+25% YoY) and ₦1.09 over FY 18 and FY 19 respectively. In addition, we forecast a dividend pay-out ratio of 20% (FY 17: 17%) which translates to DPS of ₦0.16 (FY 17: ₦0.11) and dividend yield of 7% based on current pricing.

- Post adjustments, our FVE for Fidelity increases to ₦2.92 (vs. ₦2.82 previously). We maintain our **BUY** recommendation on the stock. Fidelity trades at a FY 18E P/B of 0.36x, a premium to Diamond (0.16x) and FCMB (0.18x), which we think is justified based on its first-rate ROAE (10.8%) in FY 18E relative to Diamond (-1.1%) and FCMB (6.0%). At current price, our expected dividend of ₦0.15 over FY 18E translates to a dividend yield of ~7%.

Summary of Results and Forecast

Balance Sheet	2017	2018E	2019E	2020E	2021E
Assets					
Inv. Securities	206,238	298,059	336,325	369,066	405,018
Net loans	768,737	843,863	909,381	973,616	1,047,105
Gross loans					
Interest-earning assets	1,027,262	1,256,954	1,364,188	1,464,719	1,577,821
Total assets	**1,379,214**	**1,677,509**	**1,798,783**	**1,914,669**	**2,044,148**
Liabilities					
Borrowings	325,527	345,437	352,346	359,393	366,581
Deposits	775,276	992,730	1,089,796	1,169,955	1,249,108
Interest-bearing liabilities	1,100,803	1,338,167	1,442,142	1,529,348	1,615,689
Total liabilities	1,175,899	1,442,724	1,544,636	1,632,853	1,720,214
Shareholders' Equity	**203,315**	**234,785**	**254,147**	**281,816**	**323,934**

Income Statement	2017	2018E	2019E	2020E	2021E
Interest Income	150,742	163,642	176,463	174,967	176,073
Interest Expense	(79,278)	(87,981)	(92,517)	(89,564)	(87,525)
Net Interest Income	71,464	75,661	83,945	85,404	88,548
Net Fee Income	25,828	22,606	26,904	31,126	36,265
Gross Earnings	176,570	186,248	203,366	206,093	212,339
Staff Costs	24,535	25,401	26,298	26,959	27,501
Other Costs	40,666	41,862	43,843	45,998	48,300
Total Costs	65,201	67,263	70,140	72,957	75,801
PBT	20,302	25,941	34,343	35,784	40,635
Provision Charge	(11,315)	(5,063)	(6,366)	(7,789)	(8,377)
Tax	(1,445)	(2,335)	(2,747)	(3,578)	(4,064)
Net Profit	18,857	23,606	31,596	32,205	36,572
Dividend Paid	(3,186)	(4,721)	(6,319)	(6,441)	(7,314)

Key YoY growth rates (%)	2017	2018E	2019E	2020E	2021E
Loans	7.0%	9.8%	7.8%	7.1%	7.5%
Interest Earning Assets	1.5%	22.4%	8.5%	7.4%	7.7%
Deposits	-2.2%	28.0%	9.8%	7.4%	6.8%
Interest Bearing Liabilities	15.6%	21.6%	7.8%	6.0%	5.6%
Assets	6.2%	21.6%	7.2%	6.4%	6.8%
Gross Earnings	19.2%	5.5%	9.2%	1.3%	3.0%
Costs	-2.3%	2.4%	4.3%	4.0%	3.9%
PBT	83.5%	27.8%	32.4%	4.2%	13.6%
PAT	93.7%	25.2%	33.8%	1.9%	13.6%
EPS	93.7%	25.2%	33.8%	1.9%	13.6%

Per-share data (N)	2017	2018E	2019E	2020E	2021E
No of common shares (mn)	28,962,586	28,962,586	28,962,586	28,962,586	28,962,586
EPS	0.65	0.82	1.09	1.11	1.26
DPS	0.11	0.16	0.22	0.22	0.25
BVPS	7.02	8.11	8.78	9.73	11.18

Balance-sheet ratios (%)	2017	2018E	2019E	2020E	2021E
Loan/Assets	55.7%	50.3%	50.6%	50.9%	51.2%
Deposit/Liabilities	65.9%	68.8%	70.6%	71.7%	72.6%
Loans/Deposits	99.2%	85.0%	83.4%	83.2%	83.8%
Assets/Equity	6.8	7.1	7.1	6.8	6.3

Asset Quality	2017	2018E	2019E	2020E	2021E
NPLs	50,662	54,291	50,192	50,577	48,652
NPLs/Gross Loans (%)	6.4%	6.1%	5.3%	5.0%	4.5%
Credit change (%)					

Margins (%)	2017	2018E	2019E	2020E	2021E
Asset Yield	14.8%	14.3%	13.5%	12.4%	11.6%
WACF	7.7%	7.2%	6.7%	6.0%	5.6%
NIM	7.0%	6.6%	6.4%	6.0%	5.8%

Costs (%)	2017	2018E	2019E	2020E	2021E
Cost/Income	67.5%	68.4%	63.3%	62.6%	60.7%
Effective tax rate	7.1%	9.0%	8.0%	10.0%	10.0%

Profitability ratios (%)	2017	2018E	2019E	2020E	2021E
RoAE	9.7%	10.8%	12.9%	12.0%	12.1%
RoAA	1.4%	1.5%	1.8%	1.7%	1.8%

Source: Company Financials, ARM Research

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TOP 20		NON-TOP 20	
Rating	**Deviation**	**Rating**	**Deviation**
STRONG BUY	>20%	**BUY**	>20%
OVERWEIGHT	10% — 20 %	**NEUTRAL**	5% — 20 %
NEUTRAL	0% — 10 %	**SELL**	<5%
UNDERWEIGHT	-5% — 0%		
SELL	<-5%		

RECOMMENDATION KEY	
Rating	**Recommendation**
BUY	Accumulate security to a substantial extent constrained only by portfolio diversification considerations
OVERWEIGHT	Accumulate security to an extent moderated by cognizance of its benchmark weight
NEUTRAL	Maintain status quo for security with respect to current holding—i.e. keep if already holding and don't buy otherwise—subject to reasonable portfolio constraints
UNDERWEIGHT	Minimize exposure to security taking cognizance of its index weighting
SELL	Sell-off security completely from portfolio
RESTRICTED	In certain circumstances, Asset & Resource Management ("ARM") Group policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of ARM Securities' and/or ARM Group's engagement in an investment banking transaction and in certain other circumstances.

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